

III. PUTTING THE BUILDING BLOCKS IN PLACE

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To reclaim our future, we must strive to close both the budget deficit and the investment gap.

Governor Bill Clinton
Senator Al Gore
Putting People First
1992

With regard to Congress, if I could do one thing, I would pass a balanced budget that would open the doors of college to all Americans and continue the incremental progress we've made in health care reform.

President Clinton
November 10, 1996

President Clinton has pursued a disciplined but fair budget policy, working with Congress to make the tough choices that have dramatically cut the deficit while protecting the values that Americans share. He has cut wasteful and lower-priority spending while protecting safety net programs and investing in the future.

The results are clear: The deficit has fallen by a whopping 63 percent—from \$290 billion in 1992, the year before the President took office, to \$107 billion last year. Now, with this budget, the President proposes to build on that progress by balancing the budget for the first time since 1969.

Why must we finish the job?

What the Administration Inherited

Large budget deficits damage the economy, hurting taxpayers and discouraging businesses. The sharply higher deficits that began in 1981 have been a serious drag on the Nation's economic performance ever since.

The Debt and What It Means for the Average Citizen: The budget deficit is the annual amount that the Government spends in excess of what it receives in revenues. The Federal debt, by contrast, is the total of the

accumulated deficits that have not been offset by surpluses over the years.

At first blush, deficits may appear painless; they allow the Nation's leaders to avoid the hard choices needed to bring spending in line with revenues. But the Government must finance the debt that it accumulates, and the cost of doing so prevents the Nation from meeting future spending needs or cutting taxes.

The Government finances the deficit mainly by borrowing from the public, including foreign investors. The large deficits of the 1980s and early 1990s quadrupled the Federal debt. At the end of 1980, Federal debt held by the public was \$710 billion. By the end of 1992, it had grown by \$2.289 trillion—to \$2.999 trillion.¹ Because the deficit has fallen under this Administration, the debt has risen more slowly, and, in fact, the ratio of the debt to our Gross Domestic Product (GDP) has declined. But until we balance the budget, the debt will keep growing.

In a sense, today's deficits are the legacy of the much larger deficits of the years from 1981 to 1992. The budget would be

¹ This measure excludes the debt held in Federal trust funds. It counts only the debt held directly by private investors and the Federal Reserve System.

balanced today if not for the interest that we pay on the deficits accumulated in those 12 years.

The Federal Government paid \$241 billion in interest last year—\$241 billion that it could have spent in far more productive ways. If the Government were not paying interest at all, it could have used those funds to have a balanced budget and still have \$134 billion left over—which equals half of the military budget, or about 40 percent of Social Security payments, or about 20 percent of income taxes.

How Deficits Have Damaged the Economy: The economy did not perform as well from 1980–1992 as before, partly due to the rise in Federal debt that marked the period. As this experience shows, persistent deficits reduce saving, raise interest rates, stifle investment, and cut the growth of productivity, output, and incomes.

During recessions, when private consumption and investment declines, Government borrowing to finance unemployment and other benefits and to make up for reduced income taxes maintains demand and helps to turn the economy around. But if deficits become “structural”—that is, they persist even in good times—they can cause harm. That’s what happened in the 1980s.

A structural deficit—especially when sustained for a long time, as in the 1980s—depletes the Nation’s pool of saving. Saving provides the resources to build the new factories and machinery that generate tomorrow’s incomes. National saving has two components:

- private saving (by individuals and businesses—the net result of millions of savings decisions); and
- public saving (by Federal, State, and local governments, which save when they run surpluses and *dis-save* when they run deficits).²

If the Government taps the savings pool to finance its deficit, that borrowed saving is not available to make productive private

investments. With its massive deficits in the 1980s, the Government drained much of the pool. Worse, as Federal deficits were rising, private saving was falling, exacerbating the overall saving problem.

In each year of the 1960s, net national saving³ totaled at least 10 percent of GDP (see Chart III-1). Since then, net saving has fallen substantially. After averaging about eight percent of GDP in the 1970s, the net national saving rate fell to five percent of GDP in the 1980s, and hit a low point of just 2.4 percent of GDP in 1992.

With less saving, interest rates remained high in the 1980s, choking off demand for private investment. Why? Because lower saving shrinks the pool of available funds. The Federal Government taps the pool first by selling its bills, notes, and bonds at auction, leaving private borrowers to compete for what’s left. With so many would-be borrowers, and so little left to borrow, the competition forces interest rates higher.

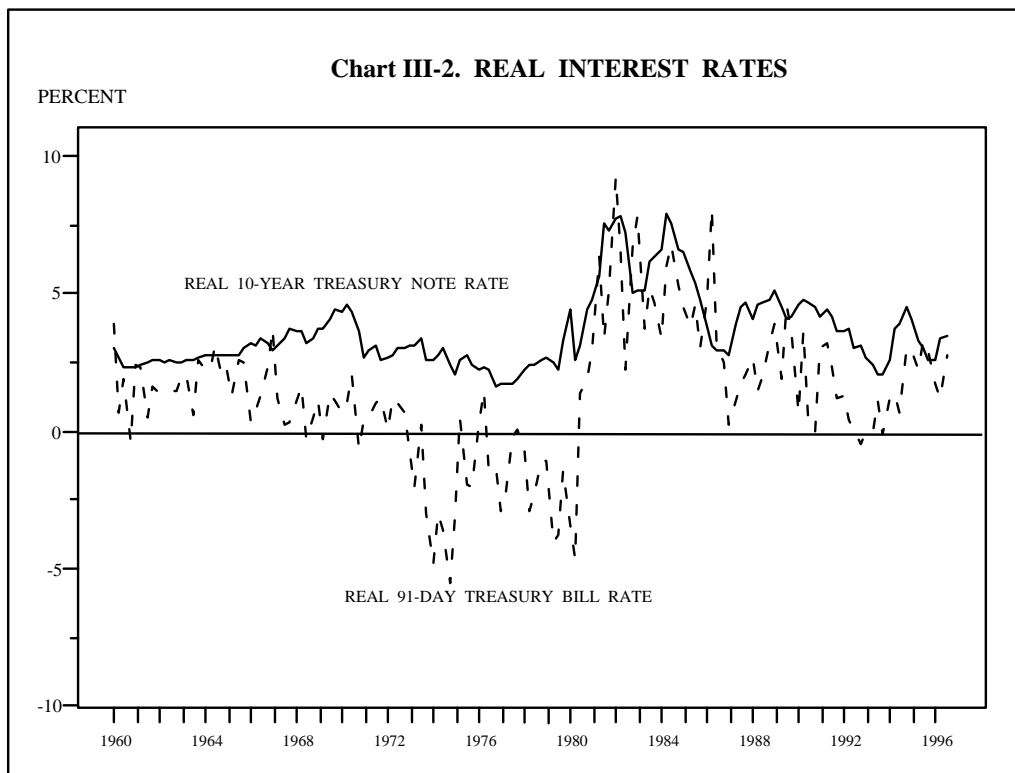
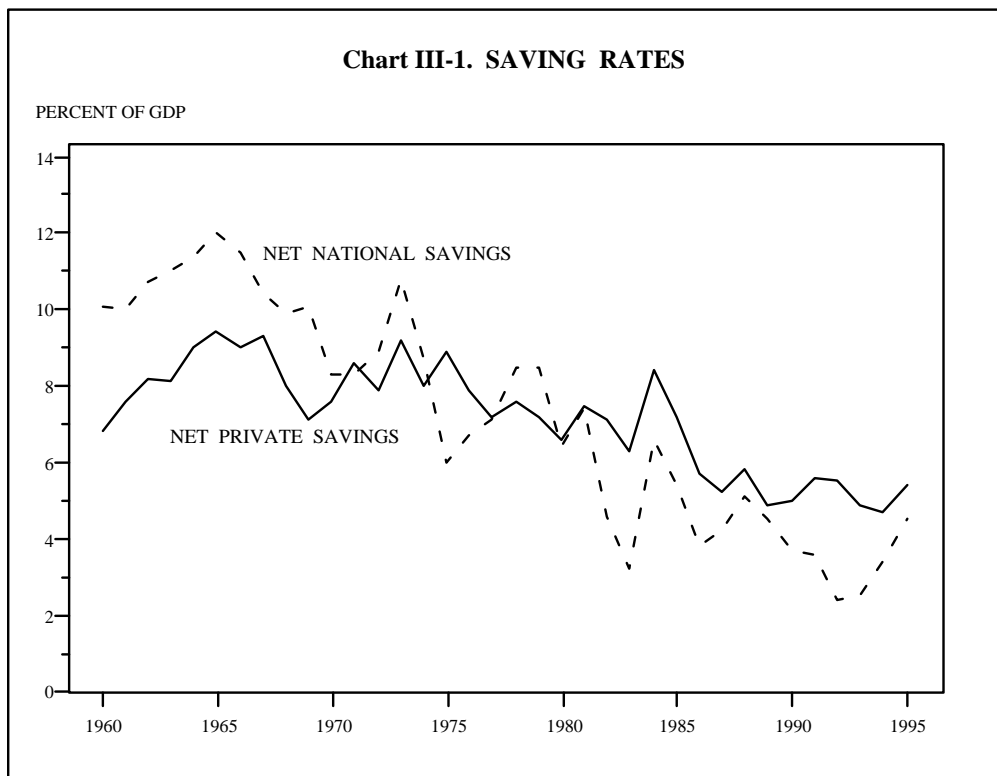
Real interest rates—that is, the portion of the rate that exceeds inflation—were markedly higher in the 1980s than in the prior three decades. In real terms, short-term rates had actually been negative for much of the 1970s, but they averaged almost four percent in the 1980s; long-term real interest rates were as much as two to three percentage points higher than in the prior three decades (see Chart III-2).

Under this Administration, saving has rebounded, mainly due to lower deficits. In the first three quarters of calendar 1996, net national saving averaged 5.4 percent of GDP. In fact, over 90 percent of the improvement in the net saving rate in the last four years is attributable to lower deficits.

Higher real interest rates in the early 1980s attracted foreign capital into the United States, driving up the dollar in foreign exchange markets. The foreign capital helped offset some of the fall in domestic saving and helped to cushion U.S. investment. But it came at a price. The higher dollar pushed up the U.S. trade deficit significantly, causing competitive problems for American manufac-

²Recently, the Commerce Department’s Bureau of Economic Analysis modified the national income accounts to measure more accurately how government at all levels contributes to saving.

³That is, gross saving minus depreciation of the Nation’s capital stock.



turers and industrial workers. The Nation entered the 1980s as the world's largest creditor; it left as the largest debtor.

Thus, big deficits unsettle potential investors—they raise interest rates, increase the risk of ballooning future Government credit demands and higher inflation, and create uncertainty in the currency markets. In response, business decision makers and other investors will likely buy safer, shorter-term securities rather than risk their money in long-term commitments for new factories, machines, and other productive investments. As a result, investment declines, and the economy is poorer for the foreseeable future.

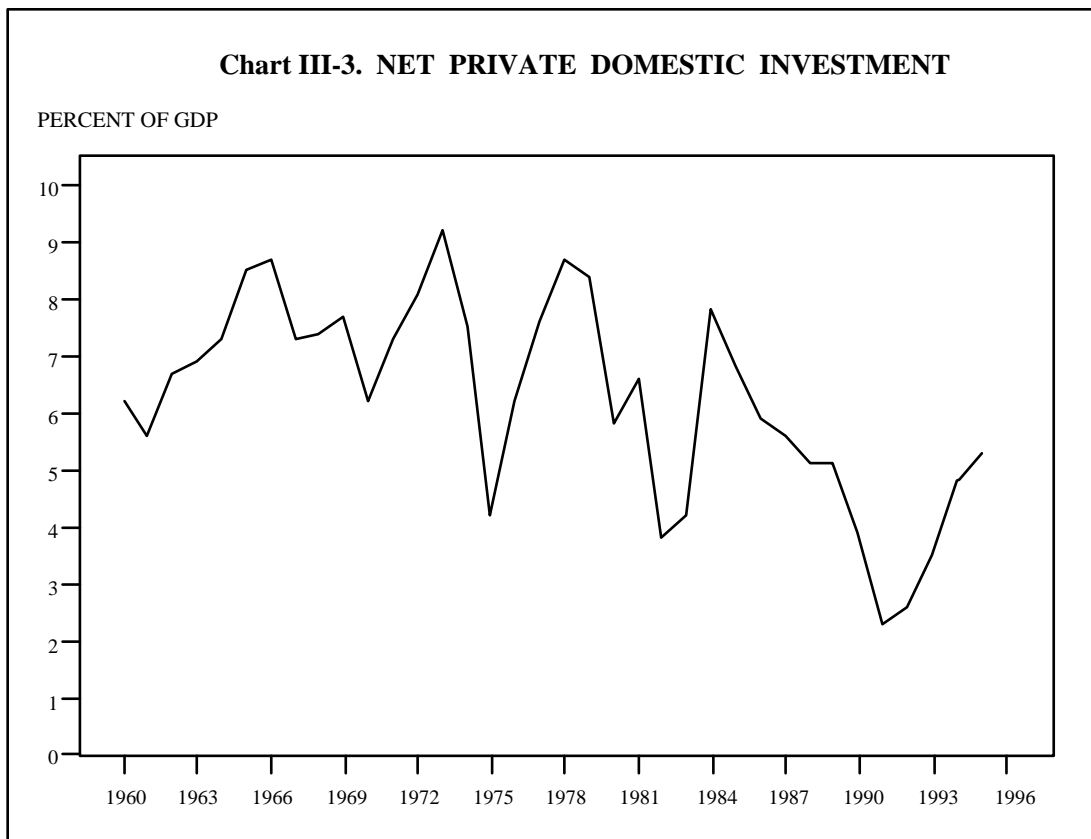
And, in fact, despite the increase in borrowing from abroad, net investment⁴ fell in the 1980s. The share of net private domestic investment (including residential and nonresidential spending) fell from over seven percent to five percent of GDP (see Chart III-3).

⁴That is, gross investment minus depreciation of the Nation's capital stock.

By 1992, the ratio of net investment to GDP had dropped to just 2.5 percent.

With the rise in net saving since then, net investment has rebounded. Equipment investment, which includes computer purchases, has risen especially rapidly—with the increases averaging 11 percent a year in inflation-adjusted terms.

The economy grew much slower in the 1980s than in prior decades, partly due to the fall in saving and investment. From the business cycle peak in 1960 to the peak in 1980, real economic growth averaged 3.7 percent a year—compared to 2.6 percent during the business cycle of the 1980s. By reducing national saving, the 1980s-era deficits held down capital formation enough to cut real potential GDP at the end of the decade by an estimated 2.5 to 3.5 percent. If incomes had been three percent higher in 1996, the average person would have had \$600 more in disposable income to spend.



Growth has improved in the past four years, compared to 1988–1992. In fact, private-sector GDP has grown since 1992 faster than in either of the two previous Administrations. Because the government component of GDP is shrinking now, whereas it rose rapidly in the 1980s, the overall numbers do not fully reflect this strength.

Still, several factors continue to hold the economy back. First, the stagnant saving and low investment of the 1980s and early 1990s are still having an effect. Only years of higher investment will offset the capital that was not put in place over the preceding 12 years. Second, the labor force is growing more slowly. And third, the recent slow growth of the major European economies and Japan has constrained the exports of even the newly revitalized and competitive U.S. economy.

What the Administration Has Accomplished

When the President took office, the deficit was high and rising. It had reached almost five percent of GDP in 1992, and projections suggested that it would not fall below four percent of GDP even during the anticipated economic recovery over the following four years. Then, according to the projections, the deficit would rise again, and continue rising without limit in the future.

The President took action.

The Omnibus Budget Reconciliation Act of 1993 (OBRA 1993): Upon taking office, the President proposed a five-year deficit reduction program that was largely enacted later that year as OBRA 1993.

The law was designed to cut projected deficits from 1994 to 1998 by a total of \$505 billion, cutting spending and raising revenues about equally. Of the spending cuts, about \$100 billion came in entitlement programs, mostly in health care programs (although expanded health coverage offset some of the savings); other cuts came in discretionary spending and interest costs. All income tax rate increases fell on the top 1.2 percent of families. At the same time, the plan cut taxes for 15 million working families by expanding the Earned Income Tax Credit.

But, largely because the economy has performed better than expected, the Administration now projects that the plan will cut the 1994–98 deficits by \$924 billion (see Chart III–4). Specifically, the plan helped cut interest rates and spur growth, thereby generating more Federal revenues and less spending on unemployment compensation and other social benefits. Lower interest rates also helped to cut Federal costs for deposit insurance and for servicing the debt. Meanwhile, the Administration's push for health care reform helped to slow the rise in health care inflation, thus helping to slow the growth in Medicare and Medicaid.

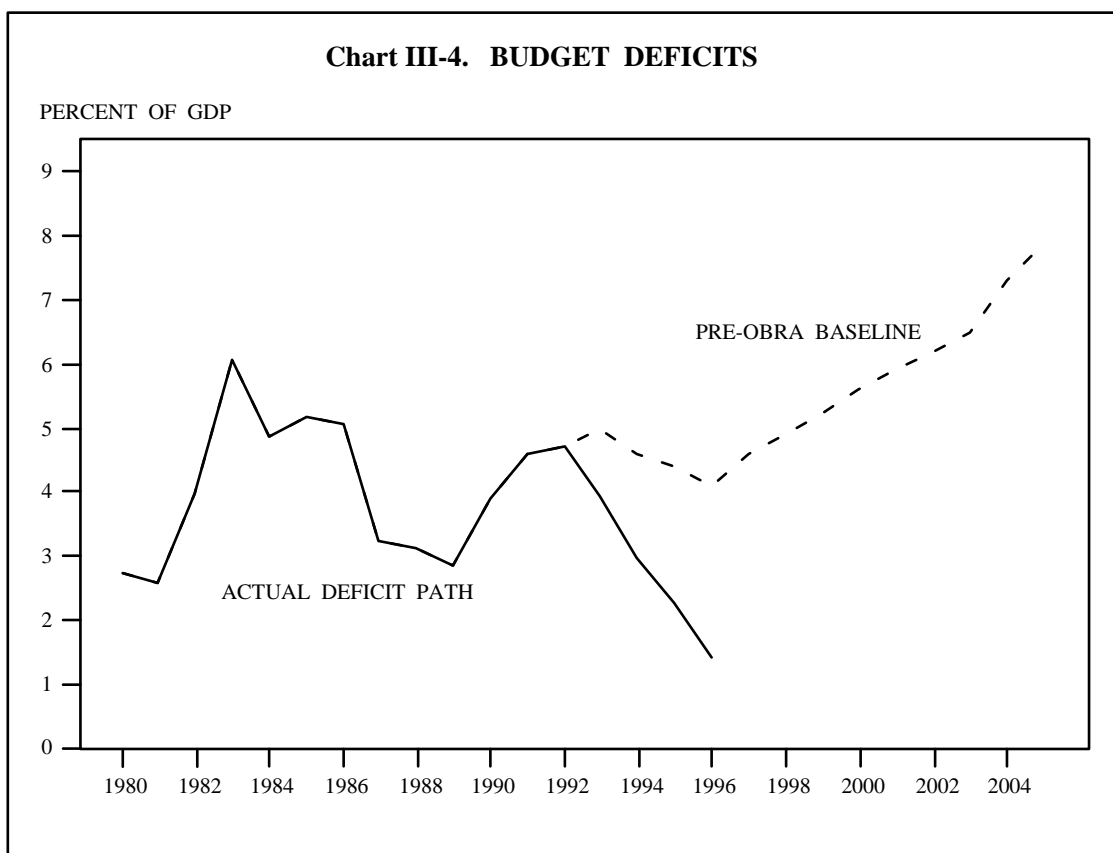
While cutting the deficit, the President's plan also shifted resources toward Administration priorities in education and training, the environment, science and technology, and law enforcement. These investments were intended to raise living standards and the quality of life, both now and in the future.

Budget Cuts Since OBRA 1993: The President has continued to cut the budget the right way—eliminating wasteful and lower-priority spending while preserving key investments. The President and Congress have scrapped over 200 programs and projects entirely, while cutting hundreds more. Spurred by the Vice President's National Performance Review, departments and agencies also have cut their workforces, streamlined programs, reduced paperwork, and overhauled their procurement systems.

The Economic Benefits: The President's success in cutting the deficit is paying huge dividends.

Falling deficits enabled the Federal Reserve to hold short-term interest rates low in 1993. In addition, the markets also reacted favorably, cutting long-term rates. Just as rising deficits increase investor uncertainty about credit demands, inflation, and currency fluctuations, the prospect of continually falling deficits into the future eases uncertainty, prompting investors to risk their money on the new factories and equipment that enhance productivity and, thus, make the economy grow.

Short-term rates stayed low through the President's first year in office. As for long-



term rates, the yield on 10-year Treasury notes fell below six percent in 1993—the first time since 1972 that the rate was this low. Lower long-term rates helped to stimulate investment in housing and business equipment, spurring the recovery.

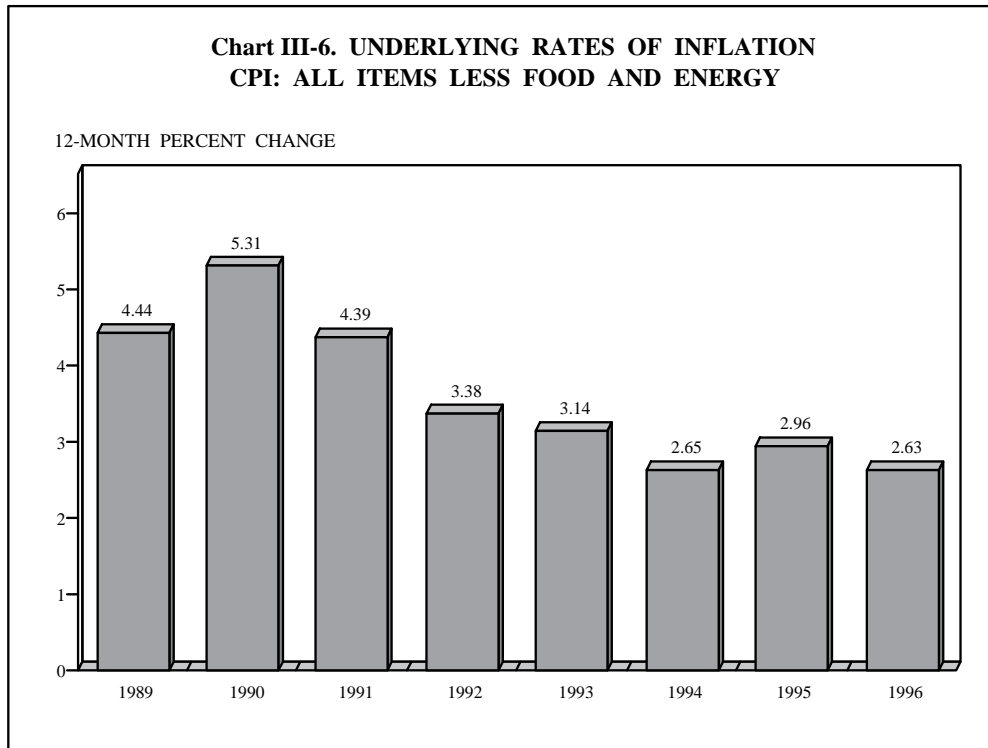
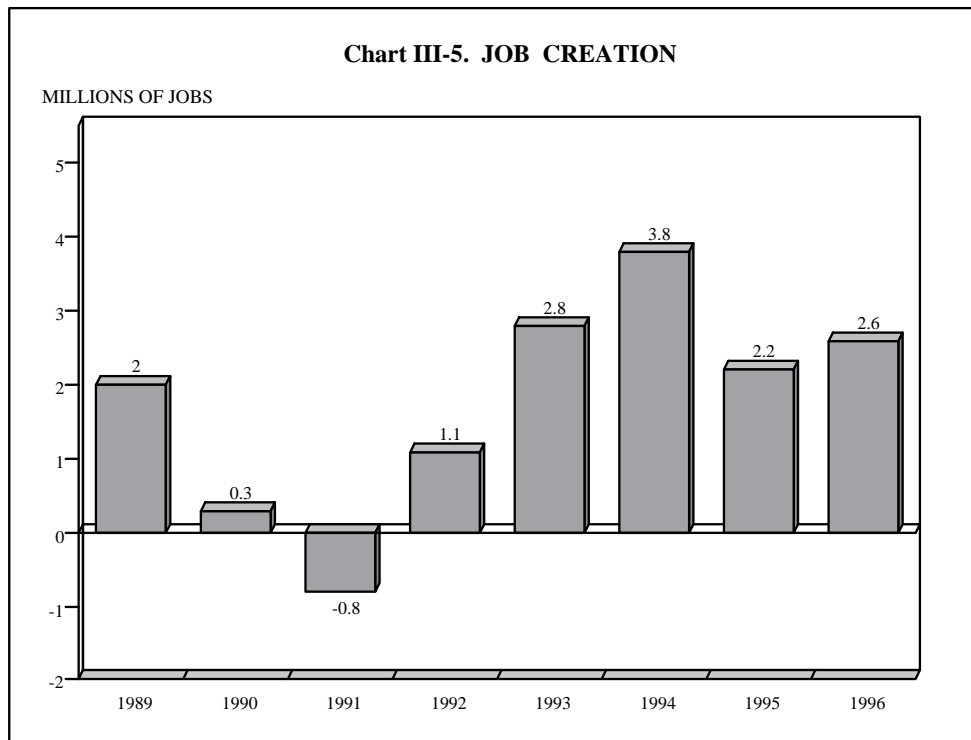
Interest rates later rose somewhat as the economy expanded, but they remained at very low levels for a rapidly growing economy with such low unemployment. In fact, the last time the economy had unemployment as low as today, the rate on the 10-year Treasury bond was about two percentage points higher.

Future interest rates likely will depend on the success of efforts to balance the budget over the next five years. A bipartisan agreement this year would greatly foster chances of further cuts in both short- and long-term rates.

What have we learned? That, contrary to some views, deficit cutting can go hand-

in-hand with economic growth—if the deficit cutting allows the Federal Reserve to maintain low interest rates, and if it's credible in the financial markets. In the months between the announcement and enactment of the President's 1993 economic plan, economic activity picked up. As shown in the monthly employment reports, job gains accelerated, and over the next four years, the economy created over 11 million new jobs—about 93 percent of them in the private sector (see Chart III-5).

The job gains occurred without an increase in inflation, which has been remarkably stable for several years. Although the Consumer Price Index (CPI) rose a bit more last year, the increase was due to faster increases in volatile food and energy prices, which experts do not expect to see again this year. If anything, the underlying rate of inflation has fallen (see Chart III-6).



Family Incomes, Poverty, and Inequality:

More jobs, low inflation, and steady growth can foster a widely shared rise in living standards, as witnessed by the last two years. After many years of, at best, modest gains in median family income, 1995 witnessed one of the largest real gains in two decades—1.8 percent. Moreover, people in all kinds of households gained. Poverty fell for the second straight year (see Chart III-7), and groups at the bottom of the income distribution actually enjoyed larger percentage gains than those at the top.

The stronger investment climate also sent stocks much higher. The Dow-Jones Industrial Average has risen an average of 18 percent a year from December 1992 to December 1996—more than half again as fast as in the prior 12 years. Corporate profits, the underpinning for the value of stocks, also have soared. Just as important, the profit gains have not come at the expense of wages, which have risen in this period, but are mainly due to falling corporate interest

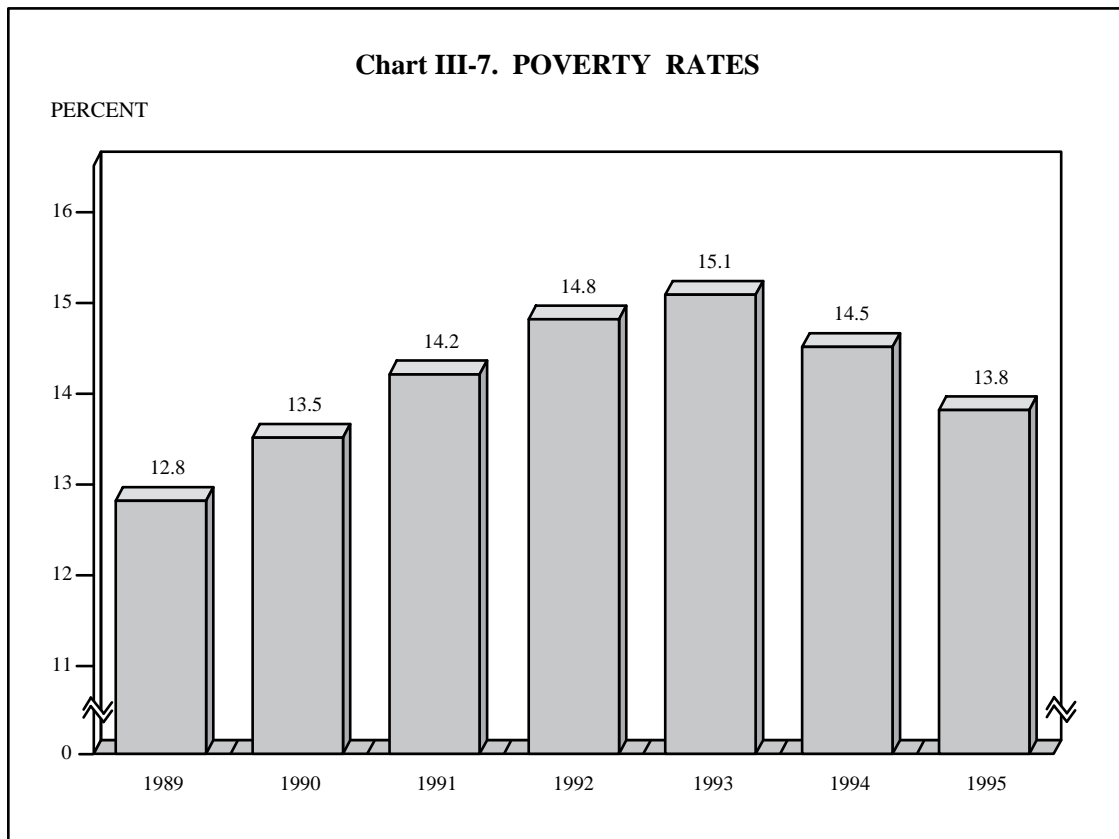
payments and a slowdown in employers' health insurance costs.

To be sure, the strong economy is not due to the President's budget policy alone. But just as surely, his policies have contributed to a stronger financial climate, enabled the Federal Reserve to maintain low interest rates, released extra saving for private investment, and showed skeptics that the Nation's leaders could cut the deficit. These successes have played their part in revitalizing the economy in the last four years.

What Remains To Be Done

The best way to preserve and strengthen the current economic expansion is to cut the deficit further. This budget reaches balance in 2002—a goal widely shared by Congress and the public. The President is committed to achieving it, and his previous success in cutting the deficit puts it well within reach.

But the goal of reaching balance is not without controversy. Some observers would



balance the budget *every* year—no matter what the circumstances; they even would enshrine the goal in the Constitution by passing an amendment to that effect. Others argue that further deficit cutting is unnecessary, if not economically harmful. Both of these visions are misguided.

A *Balanced Budget Requirement*: A requirement to reach balance every year is potentially harmful. Virtually all taxes, and many spending programs, respond automatically to changing economic conditions. That is, when the economy is weak and incomes fall, income tax revenues fall as well; unemployment compensation and other benefits also cushion the effect of the downturn on consumer buying power. Without these “automatic stabilizers,” economic downturns would be much worse.

Consider what could happen under a balanced budget amendment. A weak economy would mean fewer tax revenues and more spending on unemployment and other programs. As a result, a balanced budget requirement could force a tax increase or spending cuts—or both—in the middle of a recession. Those steps would make a weak economy even weaker.

Nor are any “escape hatches” from the budget-balancing requirement—for times of economic distress—guaranteed to work. One reason is that economists are notoriously slow to recognize economic downturns. Consequently, by the time they saw the slowdown and Congress acted to ease the balanced-budget requirement, the economic damage would be done. The better practice is to aim for balance, but to adjust budget policy according to circumstances.

A *Reversal of Course*: Allowing the deficit to begin rising again would be economically damaging. Admittedly, as some analysts argue, continued economic growth and low interest rates could keep Federal debt growing more slowly than the economy as a whole, and that would help to keep Federal interest costs under control. The problem is, the Nation faces some important challenges in the not-so-distant future for which we should begin to prepare. A balanced budget would be a good first step.

Today, the Nation is benefitting from its demography. Its largest population group—the “baby-boom” generation, born between 1946 and 1964—is entering its highest-earning years. They pay much more to the Government than they receive in direct benefits. But the situation will begin to change in about 12 years.

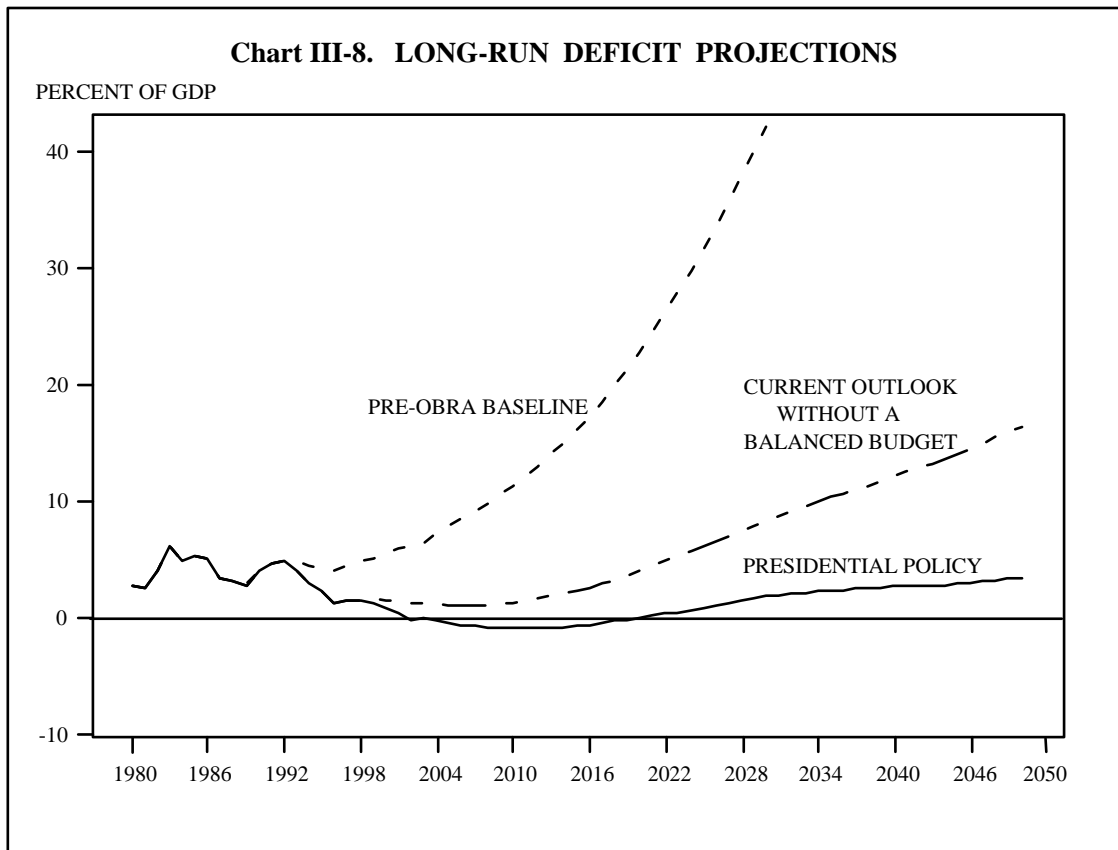
At that point, the oldest baby-boomers will become eligible for early retirement under Social Security. Because the next generation of taxpayers is smaller in size, they will contribute relatively less to the Government in revenues, making it harder to support the baby-boomers in their retirement. The President has already called for a bipartisan process to address that problem. But if we don’t balance the budget beforehand, the challenge of supporting the baby boomers will only grow larger.

A balanced budget by 2002 will add a margin of safety into the budget to absorb the coming demographic burden—and any unforeseen problems before then. As illustrated in Chart III–8, if Congress enacts the President’s budget and continues his proposed limits on Medicaid while controlling discretionary spending beyond 2002, the Government should be able to avoid an explosion of debt when the baby-boomers retire. (See Chapter 2 of *Analytical Perspectives* for a full discussion of the methodology underlying these projections.)

The Administration’s Economic Assumptions

This budget, like the Administration’s previous budgets, is based on prudent assumptions about economic growth, interest rates, inflation, and unemployment for the foreseeable future. As with the previous budgets, the assumptions are close to the consensus among private forecasters. While the Administration believes that, with sound policies, our economy can do even better, we also believe that we should use prudent, mainstream economic assumptions for budget planning.

The Congressional Budget Office (CBO) also prepares economic assumptions with which to evaluate budget proposals. In the past four years, CBO’s assumptions generally have



been quite close to this Administration's, although small differences can generate large gaps in budget projections over five to seven years.

In recent years, the economy generally has performed somewhat better than either the Administration or CBO had projected, showing faster growth and lower unemployment and inflation.

The Administration's assumptions include the following:

- **Growth:** Real growth will dip slightly below the trend for the next two years, averaging two percent on a fourth quarter over fourth quarter basis. Later, real GDP growth will average 2.3 percent per year—the Administration's estimate of its potential growth rate.
- **Interest rates:** If Congress enacts the President's budget plan, interest rates will fall as the budget approaches balance. The yield on 10-year Treasury notes, 6.3 percent at the end of 1996 and higher earlier

in the year, will decline to 5.1 percent and then stabilize; on a discount-basis, the 90-day Treasury bill rate will drop to four percent, from around 5.1 percent. The long-term real rate will be about 2.5 percent, and the short-term real rate about 1.5 percent. These real interest rates are consistent with U.S. experience during past periods of steady growth and low inflation.

- **Inflation:** Inflation will remain fairly stable. The CPI will rise an average of 2.7 percent a year from 1997 through 2002, down slightly from the 3.3 percent increase in 1996 (which was aggravated by special factors). The price index for GDP (measured on a chain-weighted basis) will rise at a 2.6 percent annual rate—somewhat faster than in 1996. The gap between these two measures of inflation, which has been large in the past, will narrow due to recent and forthcoming changes to the methodology underlying both indexes—including improved measures of health care

inflation (due later this year) and an update of the CPI market basket (effective in 1998).

- **Unemployment:** Civilian unemployment will be 5.5 percent by the start of 1998, very near the current rate, and the average level will remain there.

The Administration does not forecast the economy's cyclical pattern beyond the next few quarters; within that horizon, it sees

no sign of an impending downturn. If the economy continues to grow for the entire forecasting period, the current expansion would become the longest in this century.

In some years, growth may exceed 2.3 percent; in others, it may fall a bit short. But, the Administration's assumptions should be, on average, close to correct for this period, and should provide a sound basis for reaching balance by 2002.

Table III-1. ECONOMIC ASSUMPTIONS ¹

(Calendar years; dollar amounts in billions)

	Actual 1995	Projections						
		1996	1997	1998	1999	2000	2001	2002
Gross Domestic Product (GDP):								
Levels, dollar amounts in billions:								
Current dollars	7,254	7,577	7,943	8,313	8,717	9,153	9,610	10,087
Real, chained (1992) dollars	6,743	6,901	7,056	7,197	7,355	7,525	7,699	7,877
Chained price index (1992=100), annual average	107.6	109.9	112.7	115.7	118.7	121.8	125.0	128.2
Percent change, fourth quarter over fourth quarter:								
Current dollars	3.8	5.0	4.6	4.7	5.0	5.0	5.0	5.0
Real, chained (1992) dollars	1.3	2.8	2.0	2.0	2.3	2.3	2.3	2.3
Chained price index (1992 = 100)	2.5	2.3	2.5	2.6	2.6	2.6	2.6	2.6
Percent change, year over year:								
Current dollars	4.6	4.5	4.8	4.7	4.9	5.0	5.0	5.0
Real, chained (1992) dollars	2.0	2.3	2.2	2.0	2.2	2.3	2.3	2.3
Chained price index (1992 = 100)	2.5	2.2	2.5	2.6	2.6	2.6	2.6	2.6
Incomes, billions of current dollars:								
Corporate profits before tax	599	652	676	714	757	796	816	849
Wages and salaries	3,431	3,628	3,808	3,982	4,168	4,374	4,590	4,810
Other taxable income ²	1,532	1,612	1,684	1,748	1,809	1,882	1,967	2,068
Consumer Price Index (all urban): ³								
Level (1982-84=100), annual average	152.5	156.9	161.2	165.5	170.0	174.6	179.3	184.1
Percent change, fourth quarter over fourth quarter								
.....	2.7	3.1	2.6	2.7	2.7	2.7	2.7	2.7
Percent change, year over year								
.....	2.8	2.9	2.7	2.7	2.7	2.7	2.7	2.7
Unemployment rate, civilian, percent:								
Fourth quarter level	5.5	5.3	5.4	5.6	5.5	5.5	5.5	5.5
Annual average	5.6	5.4	5.3	5.5	5.5	5.5	5.5	5.5
Federal pay raises, January, percent:								
Military	2.6	2.6	3.0	2.8	3.0	3.0	3.0	3.0
Civilian ⁴	2.6	2.4	3.0	2.8	NA	NA	NA	NA
Interest rates, percent:								
91-day Treasury bills ⁵	5.5	5.0	5.0	4.7	4.4	4.2	4.0	4.0
10-year Treasury notes	6.6	6.5	6.1	5.9	5.5	5.3	5.1	5.1

NA=Not Available.

¹ Based on information available as of mid-November 1996.

² Rent, interest, dividend and proprietor's components of personal income.

³ CPI for all urban consumers. Two versions of the CPI are now published. The index shown here is that currently used, as required by law, in calculating automatic adjustments to individual income tax brackets. Projections reflect scheduled changes in methodology.

⁴ Overall average increase, including locality pay adjustments. Percentages to be proposed for years after 1998 have not yet been determined.

⁵ Average rate (bank discount basis) on new issues within period.